July 2014

The Dual Advantage of Long/Short Equity

Adding an allocation to this liquid alternative strategy can help investors boost their returns while lowering total portfolio risk.

Author

Charles Cook, CFA

Portfolio Strategist

Asset allocation in the current investment climate presents investors with several challenges. Around the world, fixed-income yields have fallen to historic lows since the Great Recession, and prospective real returns are likely to be exceptionally low or negative. Although we continue to view equities as an attractive asset class, many equity markets and equity-like investments have performed quite well, and valuations have risen. In addition, as investors shift away from fixed-income exposure in favor of equities[1], they are seeing more total volatility in their portfolios, while assuming a greater risk of significant loss if equities decline materially.

One solution to this risk/return dilemma is an investment that repackages the raw material of public equity markets in a way that lowers risk: long/short equity.

The Bond Problem

Over the past three decades, fixed income has served a valuable role in diversified portfolios. It reduced volatility and added downside protection while providing a positive real return. However, the next several years may prove to be more challenging for this asset class, as yields have declined to levels not seen in several decades. We believe the global economy will continue on its course of gradual improvement, and in that environment, a "normalization" of interest rates will occur, resulting in very low – or even negative – nominal and real returns for bond investors.

Periods of rising interest rates were not unusual during the bond bull market that began 30 years ago, but they have never occurred with bond coupons as low as they are now. This is an important distinction. Coupon income, the most significant component of total return to bonds over long periods of time, has historically provided a return cushion during times of declining bond prices.

[1] For more information on this, please see "Preparing for the End of the 30-Year Bull Market in Bonds," published by The Boston Company in May 2013. http://www.thebostoncompany.com/assets/pdf/views-insights/May13_Views_Insights_End_30Yr_Bull_Mkt.pdf

Over 20 years, there have been eight occasions when bond yields, as represented by the 10-year U.S. Treasury, have risen more than 100 basis points. (See Exhibit 1.) Usually, these episodes result in negative returns, although the extent of the damage is often reduced by the coupon income earned by the bonds. As of March 31, however, the coupon of the Barclays U.S. Aggregate Bond Index is 3.31%, lower than it was at the beginning of any of these prior periods of rising yields. Thus, in the current environment, bond investors have little protection from the falling bond prices that occur as yields rise.

Exhibit 1: Bond Returns During Periods of Rising Treasury Yields (Sept 1993 - Sept 2013)

Trough*	Peak*	10-Year Yield Change*	Beg Period Coupon**	Price Return**	Coupon Return**	Total Return**
10/15/93	11/7/94	287	7.83	-10.14	5.20	-5.30
1/18/96	7/8/96	153	7.34	-5.94	2.95	-3.03
10/5/98	1/20/00	263	6.98	-10.16	7.92	-2.35
11/7/01	4/1/02	125	6.66	-4.66	2.39	-2.44
6/13/03	6/26/06	212	5.87	-9.90	14.92	4.33
12/18/08	4/5/10	191	5.27	1.38	6.29	7.14
10/7/10	2/8/11	135	4.35	-4.11	1.29	-3.02
7/24/12	9/5/13	161	3.75	-6.24	3.46	-3.57

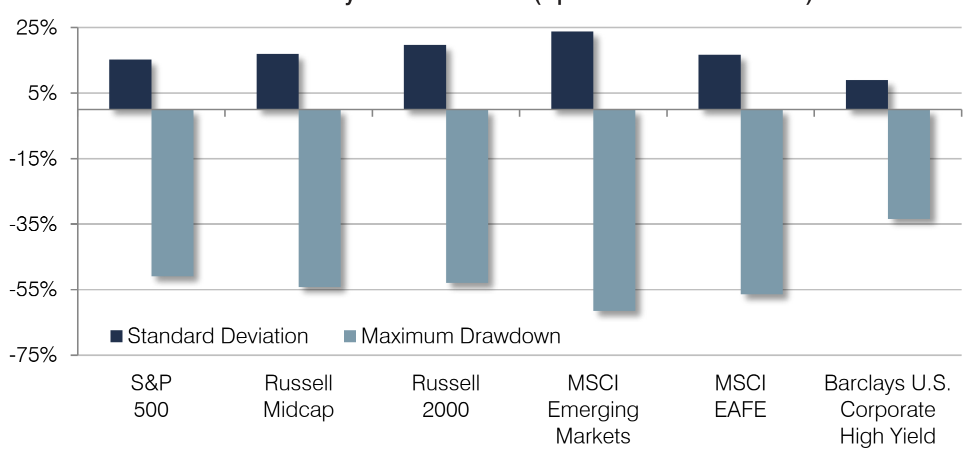
*Source: Bloomberg. **Source: Barclays Research. Bond market performance and coupon as measured by the Barclays U.S. Aggregate Index, a widely used index that represents the broad domestic fixed income market.

The Equity Volatility Problem

Based on the experiences of the past 30 years, bond investors face an unusual problem: low yields and prospective returns. Meanwhile, equity investors are contending with a familiar problem: volatility.

The bear market of 2008-09 exposed a nerve that is still raw, and many investors are understandably wary of increasing their equity exposure. Volatility and significant drawdowns are characteristic of equity markets and even some fixed-income sectors with equity-like characteristics, such as high-yield corporate bonds. Over the past 20 years, equity volatility ranged from roughly 15% for the Standard & Poor's 500 Index to almost 24% for the MSCI Emerging Markets index (see Exhibit 2) and equity markets experienced maximum drawdowns of more than 50%.

Exhibit 2: Volatility Across Indices (April 1994 – March 2014)



Source: Zephyr StyleAdvisor.

Geographic diversification across equity markets does not significantly reduce risk, and its benefits can be diminished by high levels of market volatility. Exhibit 3 illustrates the correlation of different market capitalizations in the U.S., international equities and emerging-market equities to the S&P 500 over the past 20 years.

Exhibit 3: Correlations Increase When Markets Are Volatile

	Mid Cap	Small Cap	Int'l	Emerging	HY Corp	Long/Short
Volatile Markets (Oct 07 - Mar 09)	0.97	0.96	0.92	0.84	0.71	0.68
	↑	↑	↑	↑	↑	‖
Apr 94 – Mar 14	0.93	0.81	0.83	0.73	0.62	0.67

Source: Zephyr StyleAdvisor. Correlations shown are for Russell Midcap, Russell 2000, MSCI EAFE, MSCI Emerging Markets, Barclays U.S. Corporate High Yield, and Dow Jones Credit Suisse Long/Short indices. All correlations are relative to the S&P 500 Index.

As you can see, correlations are normally high, ranging from 73% for emerging-market equities to 93% for U.S. mid-cap stocks. High-yield corporate bonds were also highly correlated with U.S. large-cap equities at 62%. As the market dropped and volatility rose from 2007 to 2009, these correlations increased even more, reducing any benefits derived from diversifying across equity markets, just when they were needed most.

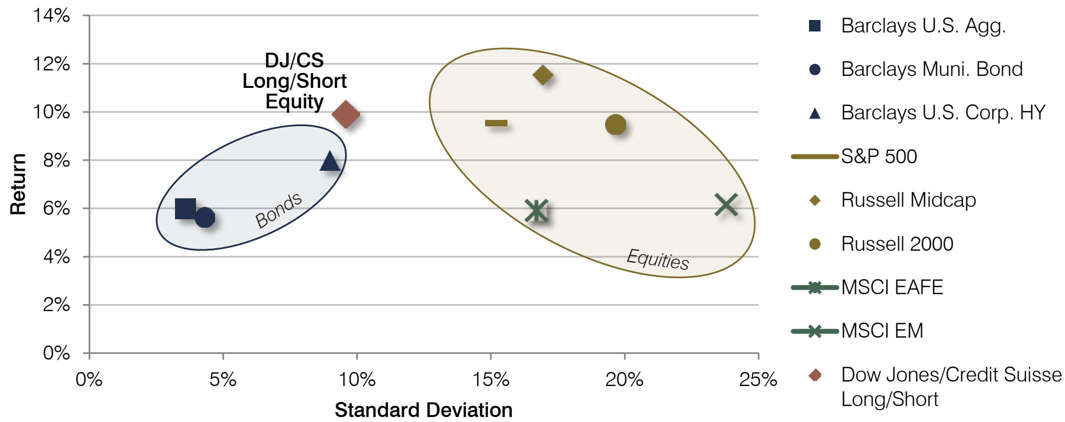
Enter Long/Short Equity

The low prospective returns for bonds and high equity-market volatility create a need for strategies that produce attractive returns with a moderate amount of risk.

Long/short investing expands the opportunity set of equity managers by removing the long-only constraint and allowing managers to purchase equities they believe will perform well and to short equities that they believe will perform poorly. The combination of a long and short portfolio reduces the market exposure, or beta, of the portfolio while capturing the relative performance, or alpha, of both the manager's long and short decisions.

Long/short equity strategies are not new, but many of them have been available only in hedge-fund form, appealing primarily to institutional and high-net-worth investors. The returns of long/short equity strategies have been comparable to or even better than those of long-only strategies, achieving this with less risk, as shown in Exhibit 4. Over the past 20 years, the total return of the Dow Jones/Credit Suisse Long/Short Equity Hedge Fund Index was 9.93%, and the risk, as measured by the standard deviation of monthly returns, was 9.58%. In comparison, the S&P 500 produced a return of 9.53% with a volatility of 15.20%. The maximum drawdown, which measures the largest drop in a portfolio's value from peak to bottom, of long/short equity was 22%, less than half that of the S&P 500 and lower than other equity strategies and higher-risk fixed-income investments. In other words, long/short equities offer risk-adjusted returns that are very competitive with their long-only counterparts.

Exhibit 4: Risk/Return (April 1994 – March 2014)



Source: Zephyr StyleAdvisor.

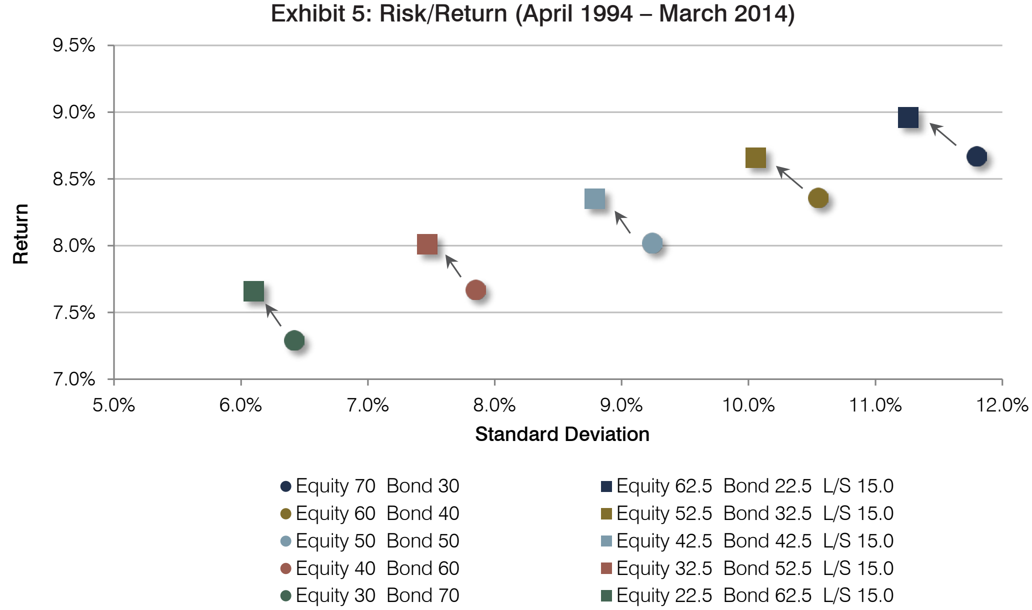
Long/short strategies based on exposure to public equity markets can also be structured to provide a high degree of liquidity and transparency. Daily liquidity is available for those strategies in mutual-fund form, and hedge funds may also offer better liquidity and transparency than other forms of alternative products.

Thus, by allowing managers to exploit a larger opportunity set while reducing market exposure, long/short equity has generated compelling risk-adjusted returns, using instruments and markets that give investors the ability to readily access their capital.

The Portfolio Benefits of Long/Short Equity

The combination of equity-like returns and lower volatility makes long/short equity an attractive addition to balanced bond and equity portfolios. By reducing equity and fixed-income exposure and adding long/short equity, investors have historically been able to lower total portfolio risk and increase return, as illustrated in Exhibit 5.

Exhibit 5: Risk/Return (April 1994 – March 2014)



Source: Zephyr StyleAdvisor. Equity: S&P 500 Index; Bond: Barclays U.S. Aggregate Index; L/S: Dow Jones/Credit Suisse Long/Short Index

For example, adding a 15% allocation to long/short equity, sourced equally from a portfolio that contains a mix of 40% bonds and 60% equities, causes annualized returns to increase from 8.36% to 8.66% and total portfolio volatility to decline from 10.55% to 10.06%. These benefits were also apparent at varying mixes of stocks and bonds and were based on a bond return of 5.99% for that period. With prospective bond returns at significantly lower levels, we believe the return advantage of adding long/short equity to balanced portfolios will be even greater, while still reducing total portfolio volatility.

Selecting the Appropriate Strategy

The universe of long/short equity strategies is made up of myriad investment approaches, constraints and risk/return characteristics. However, many funds in the long/short universe and equity hedge funds more generally are highly correlated to the broad equity market. In fact, this correlation has been rising over time and is now close to its highest level in 20 years. Although investors in long/short strategies that mimic the equity market may earn attractive returns in a rising market, they could experience significant drawdowns in times of equity-market weakness or high volatility. Investors need to examine the level of market correlation in a given strategy to evaluate whether it provides adequate downside protection.

The primary benefit of long/short equity – equity-like returns with lower risk – is available to strategies that can produce returns predominantly by taking idiosyncratic risk rather than market risk. These strategies primarily generate alpha from their ability to identify winners and losers in their long and short exposures, making them less susceptible to weak equity markets than those with significant market risk. This ability to reduce downside volatility while generating positive returns is what makes long/short equity an attractive addition to a traditional portfolio of equities and fixed income.

Conclusion

Allocations to long/short equity strategies can provide investors with the potential to increase their returns and reduce their total portfolio risk, compared with a long-only equity and fixed-income approach. Long/short solutions help solve for the dual problems of low fixed-income returns and high equity-market volatility, making this seem like an optimal time for this liquid alternative strategy.

About the Author

Charles Cook, CFA

Director, Portfolio Strategist

Chuck is a Portfolio Strategist for The Boston Company, primarily focused on communicating the firm's strategies from an investment perspective to the BNY Mellon Wealth Management group.

Before joining The Boston Company, Chuck spent 21 years at Standish Mellon Asset Management, where he served both as Senior Global Strategist and Director, Global/International Fixed Income. Previously at the firm, he held positions of increasing responsibility while gaining experience in global fixed income portfolio management, derivative strategies and currencies. Prior to that, he worked at State Street Bank & Trust Co. as a portfolio accountant.

Chuck earned a B.S. in Business from Lehigh University and an M.B.A. with a concentration in Finance from Northeastern University. He holds the Chartered Financial Analyst designation.

For more information on the market perspectives of The Boston Company Asset Management, please visit our website at http://www.thebostoncompany.com/literature/views-and-insights.html